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SUBJECT: Austrian Banks Remain Stable, CESEE Crisis Manageable

REF: (A) VIENNA 847; (B) VIENNA 839; (C) VIENNA 828

Sensitive but unclassified -- protect accordingly.

¶1. (SBU) SUMMARY: in meetings August 7-10 with Treasury Representative for Europe Mathew Haarsager, Austrian banks and regulators painted the country's financial sector situation as difficult but manageable. Three of Austria's six major banks (Bank Austria, Erste, & Raiffeisen Zentralbank) are more solidly placed than the other three (BAWAG-PSK, Volksbanken, and Hypo Alpe Adria) -- however, all six "system-relevant" banks remain sufficiently capitalized. The best performers reduced their CESEE exposure by 5% during the first quarter of 2009; used their strong first-half earnings to increase loan loss reserves; and are gradually streamlining their operations in Central, Eastern and Southeastern Europe (CESEE). Austrian banks remain committed to CESEE, but worry about other players leaving the region's banking sector (which might precipitate Russian entry). END SUMMARY.

¶2. (U) Below is a summary of insights obtained during the August 7-10 visit to Vienna of Treasury rep for Europe Mathew Haarsager in meetings with Raiffeisen International Bank (RI), the Austrian National Bank (OeNB), the Ministry of Finance (MoF), Austria's Financial Market Authority (FMA) and Erste Bank (EB).

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Regulators: Austrian Banks Healthy, Stress-Tested
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¶3. (SBU) Representatives of the Austrian National Bank (OeNB)-- which shares bank supervisory responsibility with Austria's Financial Market Authority (FMA)-- said that markets had hugely exaggerated Austrian banks' vulnerabilities earlier this year, but that sense had returned (reflected in the sharp recovery of bank stock prices since mid-March). OeNB Director for Financial Stability and Bank Inspections Philip Reading said the market hysteria in early 2009 over Austrian bank exposure to CESEE was over, with most observers subscribing to a realistic view of the situation as difficult but manageable. The three largest of Austria's six major banks -- Bank Austria, Erste Bank and Raiffeisen Zentralbank -- are strongly placed and have used their good first-half operating earnings to substantially increase loan loss provisions. The next three are weaker, but still fully solvent:
-- BAWAG-PSK (owned by U.S. private equity fund Cerberus Capital Management) reportedly has substantial "toxic" structured assets in its portfolio;
-- Volksbanken, burdened by its stake in failed specialty lender Kommunalkredit, will likely not be able to pay its (optional) interest coupon this year on GoA equity participation capital;
-- Likewise, Hypo Alpe Adria (the long-troubled subsidiary of BayernLB) likely cannot pay this year's interest on its state equity capital.

¶4. (SBU) Reading said Austrian banks are gradually streamlining their CESEE operations and in Q1/2009 have reduced their CESEE exposure by 5%, particularly their interbank exposure (ref C). Austria's positive stress test results (ref B) have been confirmed

in subsequent testing coordinated by the Committee of European Bank Supervisors (CEBS). The authorities are continuously monitoring Tier 1 capital ratios and, in a crisis, they would not wait until a bank's Tier 1 capital hits the 4% legal minimum, but rather would probably act as soon as it reaches 5%.

¶5. (U) Two thirds of Austria's banks (including all major ones) introduced internal rating systems under Basel II. OeNB/Reading opined that new international rules on capital adequacy will not necessarily endorse "arbitrary" current thresholds (8%/4%) but some kind of coordination is necessary; a new system might distinguish between systemic and non-systemic banks.

¶6. (SBU) Helmut Ettl, co-CEO of the FMA, opined that Austrian banks are hurting but have sufficient reserves to last through 2010 and beyond, even if the crisis extends into 2011. The FMA distinguishes between CESEE exposure in EU member states (Hungary, Romania, etc) and in non-member states. All banks active in Ukraine are trying to minimize risks there; the Baltic countries are no problem for Austrian banks (only BA is active in Latvia), but there are fears of contagion effects from a currency crisis in Latvia/Lithuania.

¶7. (SBU) Alfred Lejsek, Head of the MoF Financial Markets Unit, reported on the health of major financial institutions in Austria:
-- no Austrian insurance company has chosen to use capital from the GoA's rescue package, but the MoF did help insurers by allowing more flexible accounting rules for 2008 (so that they didn't bear the full pain of portfolio losses).
-- The MoF is currently negotiating with Kommunalkredit Bank, BAWAG-PSK and Bank Austria (BA) for state equity participation. With regard to nationalized Kommunalkredit, the MoF is looking into the bank's business plan.

-- BAWAG-PSK owner Cerberus recently fulfilled a precondition for the GoA's EUR 550 million equity injection by giving the bank EUR 205 million in fresh equity.
-- As a condition for state support (both in Austria and Germany), by 2013 Hypo Alpe Adria (HAA) must look to sell its subsidiaries in 6-7 CESEE countries and its owner, the German Bayerische Landesbank must sell its majority stake in HAA. Those requirements are causing further uncertainty for HAA.
-- Volksbanken was recently downgraded by Moody's and will not be able to pay interest this year on its GoA equity.
-- the GoA is expected to provide EUR 1.5-2 billion in state equity for Bank Austria/BA, contingent on undertakings by BA parent UniCredit in Milan (e.g., restrictions in dividend payments from BA to UniCredit) and GoI willingness to provide equity to UniCredit. Austria's capital injection rules (up to 9% Tier I capital ratio) are more generous that Italy's (capped at 8% Tier I capital), so Austria may end up putting more state money into the UniCredit group than the Italian government does.

¶8. (SBU) On regulatory reform, Lejsek sees many initiatives on the EU level and internationally (Basel process) but no clear direction. Lejsek prefers a European system of supervision rather than one split among several authorities and locations. The EU's desire to overhaul the Deposit Guarantee Directive will have a major impact on Austria's deposit guarantee scheme, which is organized as an ex post funding system within the sector.

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Efforts to Graduate from OECD "Gray List"
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¶9. (SBU) Lejsek told us that the MoF is currently renegotiating bilateral double taxation agreements (some negotiations are already concluded) to get off the OECD's "Grey List" of jurisdictions that don't share enough information with foreign tax authorities. The process cannot go forward, however, until the government assembles a 2/3 majority in Parliament to amend relevant laws; the GoA will try again in late August to pass amendments.

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Abiding Frustration over Harsh FATF Review
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¶10. (SBU) FMA/Ettl expressed frustration over the FATF's critical MER (Mutual Evaluation Report) on its Anti-Money-Laundering / Terrorism-Financing (AML/CFT) standards (ref A). Ettl portrayed the MER as unfairly harsh and complained about the aggressive tactics of USG representatives at the FATF Plenary in Lyon June 24-26 -- asking about any "hidden U.S. agenda" behind the campaign to list Austria as a non-cooperative jurisdiction. MoF/Lejsek took a more moderate line, expressing the GoA commitment to further improve its AML/CFT standards via a "roadmap" currently under discussion (actual implementation, which requires a number of legal amendments, will take considerable time).

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Banks: No Cause for CESEE Alarm
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¶11. (SBU) Raiffeisen International (RZB's CESEE subsidiary) representatives told us that the region's downturn is quickly morphing from a trade/industry crisis (currently ending) into a recession of the services and consumer sectors. Even with higher unemployment and lower consumer demand, the region is adapting more quickly than western Europe -- suggesting that CESEE will rebound more strongly than the Eurozone. Economic management in CESEE is generally good, with three caveats:
-- Ukraine's monetary/banking authorities leave much to be desired;
-- Host-country supervisors in CESEE are ring-fencing their markets, forcing banks to maintain exposure levels even when credit demand is lacking; and
-- The region's banks are faced with a barrage of duplicative stress tests. RZB has expressed this concern at the highest levels of the EU.

¶12. (SBU) Erste Bank representatives echoed many of Raiffeisen's sentiments, complaining for instance that Czech and Slovak authorities are counterproductively trying to stop multinational banks from using excess deposits in those countries to fund lending elsewhere in the region. Major Austrian banks are committed to stay, but Erste worries about peripheral players exiting the CESEE market -- including HAA, AIB/Ireland, Citibank, and OTP -- which would put downward price pressure on banking assets in the region. Moreover, such an exit would likely lead to an influx of Russian investment in the CESEE banking sector.

COMMENT: G-20 Commitment was Key
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¶13. (SBU) Both Austrian regulators and bank representatives say the G-20's committment in late March to augment the IMF's resources was a decisive turning point which:
-- made the Fund's efforts in CESEE more credible;
-- removed fears of a broad-based crisis; and
-- led the markets to differentiate much more among countries based on policy performance.

¶14. (U) This message was coordinated with Treasury Representative for Europe Mathew Haarsager.

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